THE SEPARATION OF DEBT MANAGEMENT AND MONETARY POLICY

Debt management is the means by which the government issues securities to finance its deficit (or retires its debt if the Budget is in surplus) and manages the costs of the resulting stock of government debt. Monetary policy is concerned with influencing the cost and availability of money and credit in order to contribute to sustained low-inflation growth. Sound financial management is more likely to be realised when the two activities are kept separate.

The essential pre-condition for this separation is that the government fully funds its deficit by borrowing from the public at market rates. Once that principle of debt management is achieved, the government no longer has to borrow from the central bank, and so it is no longer an inadvertent contributor to monetary expansion. Monetary policy can then concentrate on its central task, without being diverted by debt management issues.

This principle is followed in Australia, although it is only in recent years that this has been the case; prior to that, institutional arrangements did not support a separation of the two policies. The process by which the separation was achieved was an evolutionary one which has been described only briefly along the way.[1] The purpose of this article is to explain how the separation evolved and how the present system operates.

THE EVOLUTION OF THE PRESENT SYSTEM

(a) Deficiencies of the earlier system

Prior to 1979, primary issues of Commonwealth Government securities (CGS) were through "cash loans" or "tap" issues in which securities were offered at pre-determined rates of interest, and the authorities accepted whatever sales occurred at that rate. This meant that it was only by coincidence that sales might match the amount needed to meet the Government's financing needs. A basic tool of efficient debt management — that would see securities sold in the exact quantity desired — did not exist.

When the Commonwealth Government did not sell sufficient debt to finance its deficit, the shortfall was made up by borrowing from the Reserve Bank.[2] When it sold more than

1. Two earlier accounts are given in Phillips, M.J. 'Monetary Policy from the Inside', *Bulletin,* November 1985 and Battellino, R. and Macfarlane, I.J. 'Open Market Operations- Some International Comparisons', *Bulletin,* December 1987.
2. This finance was provided in the form of issues to the Reserve Bank of 'external' Treasury bills, which were short-term discount securities carrying a fixed discount of 1 per cent. In addition to funding the Commonwealth, external Treasury bills could also be used, under Loan Council arrangements, to finance lags in revenue encountered by State governments. The Commonwealth also uses 'internal' Treasury bills as a means to make intra-government transfers, but these are of no macroeconomic significance.

required, it accumulated cash balances at the Reserve Bank. In both situations, the result was a flow of cash to or from the money market which was outside the control of the authorities.

The implementation of monetary policy was quite difficult in those circumstances. The difficulties were of two main types:

- because of the *unpredictable* net contributions by the Government to the amount of cash in the money market, much of the Reserve Bank's open market operations (or liquidity management) was directed to offsetting or trying to prevent unwanted and destabilising injections or withdrawals of funds from this source; and
- the yields set by the authorities on CGS became important for monetary policy. If, for example, the Reserve Bank wished to tighten monetary policy, but the yields on CGS were kept constant, the aim of monetary policy would soon be thwarted — the tightening of monetary policy would push up short-term private interest rates, thus making CGS less attractive. The funding shortfall would widen, thereby increasing the Government's contribution to monetary growth and making the process self-defeating.

To further complicate matters, it was often the case that the authorities aimed to sell securities not just to finance the Government's budget but also to offset the domestic monetary effects of foreign exchange inflows or outflows. At the time, Australia operated a quasi-fixed exchange rate under which the exchange rate was announced by the authorities and the Reserve Bank bought and sold foreign exchange in whatever volume the market desired at the announced rate. These purchases and sales of foreign exchange by the Reserve Bank injected or withdrew Australian dollars from the domestic market. Through this mechanism, foreign exchange flows affected the liquidity of the financial system in much the same way as did changes in the Government's budget position. The flows were sometimes large enough that it was necessary to try to use primary issues of securities not only to finance the Government (debt management), but also to try to control the volume of funds in the money market (monetary management).

The tap arrangements for selling securities usually meant that neither goal was met. In the process, however, the sale of CGS under the tap arrangement became as much an arm of monetary policy as it was of debt management. Announcements of an increase in the interest rate being offered on debt, or of the introduction of a new instrument such as the Australian Savings Bond (ASB), were seen by financial markets primarily as indications of a tightening of monetary policy, rather than as debt management issues. The need to meet the Government's financing requirements was a constraint on the successful pursuit of appropriate monetary policy; that would not be possible unless the Government could sell its debt effectively. Implementing an efficient system for issuing debt was thus seen as the key to an effective monetary policy.

(b) Progress towards the present system

The first steps were the introduction of the tender system for Treasury notes in 1979, and for bonds in 1982. The tender system gave the authorities control over the volume of notes and bonds sold. These steps made a big difference, but the continued presence of the ASB, which remained a tap instrument for which take-up and redemption were unpredictable, still complicated the system.

While the often large and unexpected inflows and outflows of cash to and from the money market across the foreign exchanges remained a feature of the system, however, there seemed little urgency in taking steps to eliminate the remaining inflows and outflows resulting from the Budget and its financing.

With the floating of the exchange rate in December 1983, it became possible to control the level of cash in the money market through central bank open market operations. There were then potential benefits in moving to a purer, more predictable system of debt issuance through which the Government issued securities solely to meet its financing needs, but this did not take place immediately. A major problem was that the logic behind the

principle of fully funding the Budget was not as obvious then as it now appears. Even where full funding was accepted in principle, there was a range of views over exactly what should be funded. One view was that it was the domestic portion of the Budget deficit which should be funded, as this represented the Budget's direct impact on domestic liquidity and money base. Another view was that the take-up of currency (effectively zero-interest securities) by the public was part of Budget funding, so sales of other securities needed only to cover the remainder of the deficit. There was also debate over the effect of sales of Government securities to banks, with some holding that only sales of securities to the non-bank public was an effective means of financing.

It was not until 1986 that the notion that the net issue of securities by the Government each year should be equal to the Budget deficit was accepted, and the facility to issue Treasury bills to the Reserve Bank was put aside.[3] Adopting the principle of full funding implied that gross issues of securities would equal the Budget deficit plus maturities of existing debt, and could be estimated once the Budget deficit estimate was known. It was then a small further step to announce at Budget time each year the size of the expected bond tender program for that year. The continued presence of the ASB, with associated uncertainty about the amounts that might be subscribed or redeemed at any time, remained a complication in debt management until they ceased to be important in the late 1980s.[4]

Once these steps had been completed, financial markets came to accept that the bond selling program was a matter for debt management, and not an indicator of monetary policy. A further step in the process was the Reserve Bank's adoption in 1990 of its current practice of announcing changes in monetary policy, which helped eliminate any lingering tendency for the market to look for policy signals in the Government's debt management activities.

THE PRESENT APPROACH: THE CONDUCT OF DEBT MANAGEMENT

(a) Principles

Having established that Budget deficits be fully funded by the issue of securities at market rates of interest, several other important decisions have to be taken in managing the Government's debt. Nowadays these decisions are usually made with a view to minimising the Commonwealth's long-term borrowing costs, in a manner similar to that which any company would apply. The main decisions are:

- the proportions of the issue to be in Treasury bonds, Treasury indexed bonds, and Treasury notes. As a general principle, Treasury notes are intended to assist in within-year movements in the Government's accounts, with bonds financing the vast bulk of the accumulated Budget deficits (although the Government may sometimes choose to allow some of the annual deficits to be financed by changes in the base level of Treasury notes on issue);
- the proportions of the issue to be made in Australia and overseas. Bonds can be issued in Australian dollars or in other currencies. Prior to 1987, it was common for the Australian Government to issue bonds denominated in foreign currencies in overseas markets. In recent years, all bonds have been issued in Australian dollars in the domestic market, with the desired foreign currency exposure being achieved through the currency swap market by swapping

3. In June 1986, the Treasurer indicated to the Loan Council that the Commonwealth no longer intended to issue Treasury bills to the Reserve Bank to cover short-term funding needs and the Council agreed to end the use of the States' Lag-in-Revenue bills. In an exchange of letters with the Reserve Bank in August 1986, the Treasury informed the Bank that the Government would no longer make use of external Treasury bills.

4. In 1993, the Government recommenced issuing Treasury indexed bonds through a dealer panel which then distributes the securities to other buyers but, as these issues are in predetermined amounts, there is no uncertainty about their contribution to Budget funding.

some Australian dollar obligations into other currencies; and

- within each category, decisions have to be made on the timing of issues as well as which maturities and, for bonds, which coupons should be issued.

These decisions on debt management are primarily the responsibility of the Treasurer, as advised by the Treasury. In formulating this advice, the Treasury consults widely with market participants, including the Reserve Bank. The Bank is a keen follower of day-to-day movements in money market liquidity and is therefore well-placed to advise on the issue of Treasury notes. As the banker to the Government, it also has an interest in how the balance of the Commonwealth's account is moving. The Bank acts as fiscal agent for the Treasury and conducts the processing of tenders for Treasury notes and bonds, as well as the registry and automated clearing and settlement systems for these securities.

(b) Implementation

Over the course of a year it is relatively straightforward to adhere to the principle that net debt issues equal the Budget deficit. On a day-to-day basis, however, it is not possible to achieve this degree of precision: debt issues and redemptions are lumpy and irregular, while the Government's outlays and receipts are often difficult to predict. It is still necessary, therefore, to make provision for temporary mismatches between the deficit and its financing, although these mismatches are much smaller and shorter-lived than under the earlier tap financing arrangements.

This management of these temporary mismatches in cash flows involves two facilities at the Reserve Bank:

- a buffer of cash balances maintained by the Commonwealth Government to absorb day-to-day flows (the Bank pays a rate of interest on these balances which is related to market rates);
- overdraft finance, for the rare occasions when unexpected shortfalls of receipts exhaust these cash balances. Stringent terms attach to this overdraft facility: first, the Commonwealth pays interest on the overdrafts at a commercial overdraft rate, which is considerably higher than the rate at which it can issue Treasury notes; and second, the Commonwealth issues sufficient Treasury notes in the next weekly tender to discharge the overdraft.

These arrangements were entered into by an agreement between the Treasury and Reserve Bank in 1985, which was followed by an agreement in 1986 to discontinue the use of Treasury bills. The new system represented a major improvement – not only are the sizes of mismatches likely to be much smaller but, when they do occur, the Government's access to central bank credit is for limited amounts and duration, and at market rates of interest. The earlier Treasury bill arrangement, in contrast, was open-ended in both amount and duration, and carried below-market interest rates.

THE PRESENT APPROACH: IMPLICATIONS FOR THE CONDUCT OF MONETARY POLICY

The separation of debt management and monetary policy, as now practised in Australia, leaves the Reserve Bank free to use its open market operations purely to manage monetary conditions. The Bank uses these operations to manage the overall supply of cash to the money market, so as to keep overnight interest rates in that market consistent with the desired stance of monetary policy.

Open market operations are conducted primarily in CGS, which are of uniform credit and are traded in a highly liquid market. Sales of CGS (or repurchase agreements based on CGS) reduce the supply of cash to the money market, while purchases inject additional cash. To conduct these operations, the Bank needs to hold and manage a portfolio of these securities. The Bank also has an interest in maintaining liquidity in the market for CGS, which is important for the effectiveness of its operations. In order to maintain an appropriate portfolio of CGS, the Bank makes purchases in

the secondary market and, at times, participates in primary issues of CGS at tenders.

When the Bank takes up securities at tender, the size of its subscription is announced at the same time as the other details of the tender, and it takes up its securities at the weighted average yields achieved in the tender. The Bank normally uses this channel only to replace stock maturing from its portfolio, although on occasions it has used tender subscriptions to help increase its holdings of CGS when it has needed to do so. Such a need may arise when the Bank sells foreign exchange and needs to buy CGS to sterilise the sale's impact on the money market — i.e. when the Bank is changing the composition of its assets from foreign exchange to domestic securities. Subscriptions at tenders by the Bank are entirely at the Bank's discretion, unlike the take-up of Treasury bills in the past (over which the Bank had no direct control).

The temporary mismatches which remain a feature of Government cash flows do not hinder the Reserve Bank in its monetary management activities. Indeed, the resulting day-to-day flows of liquidity to and from the money market (and, more importantly, among participants in the market) assist the Bank in using its open market operations to influence monetary conditions. These flows underpin the demand for money market cash. This is important as the Bank needs a large and stable demand for money market cash at all times so that it can operate with predictable effects on money market conditions.

CONCLUSION

The institutional reforms over the past 15 years have had the effect of facilitating the conduct of a market-based monetary policy. The introduction of the tender system for selling Government debt and the floating of the exchange rate were important steps forward, but they did not make their full contribution until 1986 when a coherent framework was established for debt management. This framework was based on the principle of fully funding the Budget from the public at market interest rates. This permitted the separation of debt management from monetary policy, contributing in the process to a more transparent system for the conduct of monetary policy.